



COUNCILMEMBER DONNA FRYE

City of San Diego
Sixth District

MEMORANDUM

DATE: December 18, 2007

TO: Macias Gini & O'Connell (outside auditor)

Mayor Jerry Sanders

Michael Aguirre, City Attorney

Mark Blake, Deputy City Attorney

Jay Goldstone, CFO/COO

Eduardo Luna, City Auditor

Greg Levin, Comptroller

Joanne Sawyer Knoll, Mayor's Representative for SDCERS

FROM: Councilmember Donna Frye *Donna Frye*

SUBJECT: Internal Controls for DROP re: Federal and State Tax Reporting
Withholding and Compliance*

I have read the *San Diego City Employees' Retirement System 415(b), (c), and (n) Compliance Strategy Report* by Mary Beth Braitman, Terry A.M. Mumford, Katrina M. Clingerman of Ice Miller LLP, Originally Issued: August 9, 2006, Revised: August 20, 2007 and the *October 26, 2007 letter from Macias Gini & O'Connell "To the Audit Committee of the City of San Diego."*

Both documents raise concerns including internal control issues, possible deficiencies and potentially serious consequences related to non-compliance with tax laws. For example, on page 1 of the Ice Miller Report, it states that: "*If even one member is paid an annual benefit greater than Code Section 415 allows, or contributes more than Code Section 415 allows, theoretically, the entire plan will be disqualified.*"

So that you may better understand my concerns, the SDCERS' Administrator, David Wescoe, recently testified to the City Council Rules Committee that SDCERS' only duty with respect to

the DROP program was administering it and determining the annual crediting of interest to the DROP accounts.

To the best of my knowledge, I have never been advised or informed on whether DROP funding or distributions are in compliance in Federal and State tax laws. Therefore, after hearing Mr. Wescoe's disclaimer and reading the Ice Miller Report, it is certainly reasonable to suspect that regulatory compliance issues have not been properly managed and disclosed.

If the taxing authorities enter into an agreement with SDCERS on the limited issues that SDCERS has put forth, I am concerned that all issues regarding the City's participation as plan sponsor may not be fully resolved. This concern includes, but is not limited to the following questions and issues. It is necessary to ensure that everything has been addressed and resolved to the satisfaction of the taxing authorities so that no remaining issues, liabilities or investigations will remain with respect to the position of the City of San Diego as "plan sponsor."

I appreciate the fact that SDCERS has sophisticated tax counsel in Ice Miller pursuing these issues for SDCERS. Because the interests of the people of San Diego, and the City as plan sponsor for SDCERS, should be identical to those of SDCERS, it is important that any resolution of these issues be comprehensive so that we do not have to deal with them again at a later time under what could be more unpleasant circumstances. It also is necessary that the City Council and secondary markets be kept informed regarding the current status and any resolution of these issues with the IRS, particularly regarding any matters related to non-compliance. As a member of the legislative body, it is my responsibility to raise these issues, ask questions and bring them to your attention. It is your responsibility to provide a response.

In addition, now that Mayor Sanders and Jay Goldstone have agreed to provide additional information related to the City's 2005 CAFR, it is appropriate to ask all of you to clarify not only the issues I have raised in this memo, but also to report and disclose any other tax compliance issues of which you are aware, so that the City may move forward in issuing its audited financial reports.

ITEM A: The Deferred Retirement Option Program

It is my understanding that the pre-tax money contributed to the DROP accounts equates to:

- The employee's pension check;
- 8% interest;
- 2% annual COLA increase;
- 3.05% of the employee's pre-tax salary;
- Another 3.05% of the employee's pre-tax which is paid by the City;
- Rollovers from traditional IRAs and 401k's

All of the money is deposited into the DROP accounts pre-tax, and all of the distributions are taken out of the DROP account tax free – whether received directly by the employee or as a rollover into a Traditional or Roth IRA.

I have not been able to determine if any of the above referenced contributions to the DROP program are reported by either the City or SDCERS to any Federal or State taxing authorities or to the employee. The same applies for any distributions.

If any of these deposits or distributions should be reported, I do not know which transactions should be the reporting responsibility of the City as opposed to the reporting responsibility of SDCERS.

If any of these deposits or distributions should be subject to Federal or State tax withholding, I do not know which should be the responsibility of the City or SDCERS.

If there is a failure to report or withhold any of the items/matters outlined above, I do not know what specific steps need to occur to prevent any assessment of taxes, fines or other charges against the City of San Diego, whether caused directly or indirectly, by SDCERS.

Therefore, please provide to me in writing responses to the following:

ITEM B. Ice Miller Report, Page 1

Page 1 states that:

*“Ice Miller is **not considering** tax reporting and withholding under the Code nor any other federal law. We are also not deliberating any state law issues.”* (emphasis added)

It is not clear what responsibility the City has with respect to the tax “reporting and withholding” requirements under State and Federal law related to the SDCERS distributions and contributions. What is clear is this: the City, as “plan sponsor” of SDCERS, exercises virtually no control over its procedures, and has little or no resources to pay fines and/or penalties resulting from SDCERS’ programs which might lead to non-compliance with tax laws.

- Can a “global settlement” of the type SDCERS and the IRS seem to be contemplating (see attached document titled **SDCERS Contribution Schedule and Settlement Amounts, dated August 20, 2007**) be accomplished without resolving the Federal tax reporting and withholding compliance issues related to contributions to or distributions from SDCERS directly or indirectly put in place by SDCERS? Is the \$43 million proposed amount due from the City disclosed in the financial report? Has it been disclosed that this information has not been provided to the City Council by management and that management has not brought forward to the City Council for discussion any IRS proposed settlement?
- When distributions from the City’s tax qualified plans (whether the DROP, 401a, 401k, SPSPs, etc.) are made to beneficiaries:
 - Does the City or SDCERS report the distribution to the applicable taxing agencies?

- Does the City or SDCERS withhold Federal and State income tax in a manner that complies with federal and state law?
- Which entity is responsible for reporting the distribution – the City or SDCERS?
- Which entity is responsible for withholding Federal and State income tax – the City or SDCERS?
- What can be done to eliminate any risk to the City from compliance failures?
- If a beneficiary moves to a state other than California and receives a distribution from a DROP account:
 - Is that distribution subject to income taxes in California or in the State in which the beneficiary now resides?
 - Does the City/or SDCERS report the transaction to the State of California or the State in which the beneficiary now resides?
- Has the City/or SDCERS been *reporting* to the appropriate State and Federal income tax authorities any of the SDCERS' distributions, including:
 - DROP distributions rolled over into Traditional or Roth Individual Retirement Accounts?
 - DROP distributions that are withdrawals where the money goes directly to the employee/retiree instead of being rolled over into an IRA?
 - Past Corbett distributions?
 - Pension checks sent directly to the retired employee?
 - The amount of the monthly pension deposited into the employee's DROP account?
 - If not, are any of these distributions exempt from reporting? Is it the responsibility of the City or SDCERS to report these distributions? Who is responsible/liable for non-reporting?
- Has the City/or SDCERS been *withholding* Federal and State income tax for distributions including but not limited to:
 - DROP distributions - whether as a lump-sum or a partial rollover into a Traditional or Roth Individual Retirement Account (IRA)?
 - DROP withdrawals where the money goes directly to the employee/retiree instead of being rolled over into an IRA?
 - Past Corbett distributions?
 - Pension checks sent directly to the retired employee?
 - Pension checks (or funds equivalent to the monthly pension) deposited into the employee's DROP account?
 - If not, are any of these distributions exempt from federal and state withholding requirements? If not exempt, is it the City's or SDCERS' responsibility to withhold these taxes?
- Has the City/or SDCERS been *reporting* to the Federal and State(s) income tax authorities any contributions being made into the various tax qualified retirement accounts (such as the 401a, 401k, SPSPs, and DROP "account") including:
 - Pre-tax contributions made by employees to the 401k;

- Pre-tax contributions made by employees to the SPSP plans;
 - The pre-tax contributions made by the City into the SPSP plans;
 - Contributions in the form of pre-tax pension checks (or funds equivalent to the monthly pension) deposited into the DROP “account”;
 - The 3.05% pre-tax contributions from the employee salary into the DROP account;
 - The 3.05% pre-tax “matching” contributions from the City as plan sponsor into the DROP accounts;
 - The 2% COLA annual increase – pre-tax into the DROP accounts;
 - The 8% annual interest credited to the DROP account – pre-tax;
 - If not, are any of these contributions exempt from reporting? If not exempt, whose responsibility is it to report all of these contributions – the City or SDCERS?
- Does the City/or SDCERS allow employees or retirees to rollover money from an IRA or a 401k *into* their DROP accounts?
 - If so, has the City/or SDCERS then allowed that same money to be distributed from the DROP accounts tax-free?
 - Does the City/or SDCERS keep track of those pre-tax contributions from IRAs or 401ks that are rolled into the DROP accounts?
 - If so, how? I ask because the Ice Miller Report states on page 26 that “*SDCERS staff has indicated that the SDCERS system does not track employer contributions as to what portion represents an offset contribution and what portion represents a pick-up (as Code Section 414(h)(2) defines the term) contribution.*” While I realize that these contributions are of a different nature, if SDCERS is not keeping track of them, perhaps SDCERS is not keeping track of other contributions as well.
 - Are there any Federal or State income tax law requirements for the City and/or SDCERS to report the employer “pre-tax” pickup contribution?
 - Whose responsibility is it to report this – the City’s or SDCERS’?
 - When firefighters convert annual leave or other non-monetary benefits into “virtual” dollars which are then used to purchase years of service (or extend the DROP program beyond five years) at an agreed price, is there a 1099 issued? Is that an event exempt from reporting? Whose responsibility is it to report this – the City or SDCERS?
 - If the City of San Diego is allowed to:
 - Not withhold or report federal and state income taxes;
 - Not issue 1099s on distributions from tax qualified plans such as the DROP program and/or the 401a, and;
 - Allow more money to be contributed into tax qualified plans than is allowed under IRC Section 415 – both on an after-tax and pre-tax basis;
 - Are these types of contributions and distributions from non-municipal tax qualified plans legal in the private sector? Or is this just a special plan for the municipal agencies?

- Does the City/or SDCERS have any knowledge of a lack of compliance with State or Federal tax and reporting laws?

ITEM C: Ice Miller Report, Pages 35 and 26

Page 35 states:

"Code Section 415(g) requires the aggregation of all plans of an employer for 415 testing purposes. Therefore, our other primary area of concern for 415 testing occurs with respect to the other defined contribution plans that are maintained by the City – the 401(k) plan and the SPSP. The City's 457 (b) deferred compensation plan is not aggregated with SDCERS...The city does not conduct Code Section 415(c) testing for its 401(a) plans (401(k), (sic), SPSP, and SDCERS). The other City plans and SDCERS are subject to qualification failure if the 415(c) testing requirement is not satisfied and individuals are contributing in excess of the limitations to the plans in aggregate. In order to address this qualification issue, SDCERS would have to coordinate with the City to test for both the dollar and compensation limits under Code Section 415(c). In order to perform this test, SDCERS must select a definition of compensation that is permitted under the Code (see next section). The pre-tax (picked up) contributions to SDCERS would not be used in the 415(c) testing. " (emphasis/underline added)

- Who (at the City or SDCERS) is working "to test for both the dollar and compensation limits under Code Section 415(c)"?
 - How is this currently being tested at the City?
 - Does the City or SDCERS advise employees on an annual basis what the maximum limits are that may be contributed to all of these tax qualified plans (401a, 401k, SPSPs, etc.) in aggregate?
 - Is the City currently in compliance with all the relevant Federal and State tax laws?
 - What is the potential financial liability to the City for lack of compliance?
 - Is this issue disclosed in the 2005 CAFR? If so, where?
- Page 35 also states that "...SDCERS must select a definition of compensation..."
 - Does the City have the responsibility to review and approve the "definition of compensation" selected by SDCERS?
 - Does the City have a responsibility to select its own definition of compensation?
- Page 35 also states that "*The pre-tax (picked-up) contributions to SDCERS would not be used in the 415(c) testing.*"
 - Why not?
 - Is Ice Miller suggesting the City should be testing the pre-tax (picked- up) contributions under 415(c)?
- Page 26 of the Ice Miller report notes that "...the SDCERS system does not track employer contributions as to what portion represents an offset contribution and what portion represents a pick-up (as Code Section 414(h)(2) defines the term) contribution."
 - So how then can this be tested?

ITEM D: Macias Gini & O'Connell Letter, Page 3

Page 3 of the October 26, 2007 letter from Macias Gini & O'Connell "To the Audit Committee of the City of San Diego" states that:

"If a SDCERS' member participates in DROP, they are entitled to receive a lump-sum benefit or periodic distributions in addition to their normal monthly retirement allowance when they leave employment with the City. A DROP participant continues to work for the City and receives a regular paycheck. The DROP participant makes reduced retirement contributions to SDCERS and the DROP participant stops earning creditable service. DROP obligations have been shown as liabilities of SDCERS in the City's financial statements."

- Macias Gini states that DROP members "... receive a lump-sum **benefit** or periodic distributions." (emphasis added) Macias Gini appears to delineate between a "benefit" and a "distribution." It is my understanding that DROP members only receive **distributions from the DROP** program - either lump-sum **distributions** or periodic **distributions**. Lump-sum distributions from DROP accounts are regularly being made and some of these distributions are in very, very large amounts (hundreds of thousands to millions of dollars).
 - Whether any of these DROP distributions -- lump sum or periodic - are taxable;
 - Whether they are issued on pre-tax (State and Federal) basis or on an after-tax (State and Federal) basis;
 - Whether a 1099/1099R is issued or is not issued;
 - Whether DROP accounts are subject to the IRS's Required Minimum Distribution regulations;
 - Whether the DROP transactions are in compliance with Federal and State law, or;
 - Whether lack of compliance may create a potential future liability for the City or SDCERS.
- There is no discussion of the fact that the City has not filed for a Private Letter Ruling on DROP. Doesn't this and the issues above need to be disclosed in light of the growing enormity of this program?
- Page 3 of the Macias Gini letter also states that "*The DROP participant makes reduced retirement contributions to SDCERS...*"
- It was my understanding that once an employee went into DROP they were retired and no longer made contributions to SDCERS. Is this correct?
 - Are these "pre-tax contributions" in compliance with Federal and State laws?
 - Does Macias Gini have a responsibility to investigate and disclose this?
 - What is the potential liability to the City if this is not OK with the IRS?
- Page 3 of the Macias Gini letter also states that "*DROP obligations have been shown as liabilities of SDCERS in the City's financial statements.*"
 - What are the specific DROP "obligations" to the City?
 - Is that reflected on the City's financial statements? Where?
 - What about the Federal and State withholding requirements? Are those reflected in the City's financial statements?
 - Is the 8% interest credited to the DROP accounts that reflected as a liability for the City in its financial statements?
 - Is the 2 % annual COLA increase on the DROP accounts reflected in the City's financial statements?

Thank you in advance for your prompt attention and written response.

** Since Macias, Gini & O'Connell is the outside auditor for both the City of San Diego and SDCERS, it seems that they are in the ideal situation to respond to my memo by providing reasonable assurance that all information regarding compliance with all applicable tax laws, both State and Federal, that should be disclosed, is being disclosed in our financial reports. In addition, I have addressed this memo to others who are responsible for helping to prepare the City's financial reports/ disclosures and would appreciate a response prior to the 2005 CAFR being re-issued. In the past, it has often been the practice of management to either ignore my requests for information or respond many months after I have made requests for information. I am hopeful that this past practice will not continue to be the norm. Also, while SDCERS has been involved with an IRS VCP, the City Council has not been informed by management as to the issues potentially facing the City, nor has any City Council discussion regarding a settlement with the IRS taken place.*

CC: Honorable City Councilmembers
Andrea Tevlin, Independent Budget Analyst
SDCERS Board of Trustees
Stanley Keller, Independent Consultant

DF/ks

SDCERS CONTRIBUTION SCHEDULE AND SETTLEMENT AMOUNTS

ARC is for Fiscal Year	Valuation Report Date	Prepared By	ARC Amount	Payment Dates	Amount Paid to Date	Amounts Due from City per IRS (Amounts Due Established Per IRS Settlement)	Amount Paid Over the ARC Since 7/12/05
7/1/2005 to 6/30/2006 Extra City Contribution Received Extra City Contribution Received	6/30/2004	GRS (Note: Cheiron replicated numbers)	\$156.0 M	7/1/2005 6/22/2006 6/29/2006	\$163.0 M \$100.0 M \$8,298,430	(Note: Initial IRS filing made 7/12/05. Additional filings proposing additional City contributions made 4/19/06, 5/9/06, 6/7/06, 6/13/06, 6/19/06, and 6/22/06.) * 401(h) for First Period: \$31,618,356 Retiree Health Administrative Expenses: \$2,211,895 10% Disability Overpayment: \$1,221,543	\$108,298,430**
7/1/2006 to 6/30/2007 Extra City Contribution Received Extra City Contribution Received	6/30/2005	Cheiron	\$162.0 M	7/1/2006 6/29/07 6/30/07	\$162.0 M \$6.2 M \$808,977	(Note: IRS filing on 415 made 8/6/06) *** 415 Excess Benefits: \$8,160,027	\$7,008,977
7/1/2007 to 6/30/2008 Extra City Contribution Received	6/30/2006	Cheiron	\$137.7 M	7/2/2007 7/2/2007	\$137.7 M \$27,334,773		\$27,334,773
GRAND TOTALS			\$455,700,000		\$605,342,180	\$43,211,821	\$142,642,180

* Settlement amounts in this group calculated as of June 30, 2006. Includes interest at 8% to June 30, 2006.

** Did not include difference between \$163 and \$156 M since paid 7/1/05 prior to first filing with IRS on 7/12/05.

*** Settlement amounts calculated as of June 30, 2007. Includes interest at 8% to June 30, 2007.